



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, November 2003

Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting

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1. INTRODUCTION

1. The Regulation (EC) No 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards¹ (IAS Regulation) harmonises the financial information presented by public listed companies in order to ensure a high degree of transparency and comparability of financial statements.

2. The Fourth Council Directive 78/660/EEC of 25 July 1978² and the Seventh Council Directive 83/349/EEC of 13 June 1983³ are the main harmonization instruments in the accounting field within the European Union.

3. In this paper, the Commission comments on topics where authoritative clarification appears to be required. The topics have been chosen after taking into account discussions in the Accounting Regulatory Committee set up pursuant to Article 6 of the IAS Regulation as well as discussions in the Contact Committee set up pursuant to Article 52 on the Fourth Council Directive.

4. The views expressed in this paper do not necessarily represent the views of the Member States and should not, in themselves impose any obligation on them. They do not prejudice the interpretation that the Court of Justice, as the final instance responsible for interpreting the Treaty and secondary legislation, might place on the matters at issue.

5. Both the Accounting Regulatory Committee and the Contact Committee consist of representatives of the Member States and the Commission. The Accounting Regulatory Committee assists the Commission in the endorsement of international accounting standards, while the Contact Committee has an important function to facilitate a harmonized application of the Accounting Directives through regular meetings, dealing in particular with practical problems arising in connection with their application.

6. The International Accounting Standards (IASs) and the Interpretations of the Standing Interpretations Committee (SICs) referred to in this paper are those that were adopted by the International Accounting Standards Board (IASB) in April 2001, when the IASB endorsed the body of IASs issued by its predecessor, the International Accounting Standards Committee (IASC). The accounting standards that the IASB will develop will be called International Financial Reporting Standards (IFRSs) and the interpretations of IFRSs will be published as interpretations of the International Financial Reporting Interpretations Committee (IFRICs).

7. For the purpose of this paper, IASs and IFRSs are referred to as either IASs or IFRSs; SICs and IFRICs are referred to as either SICs or IFRICs.

¹ OJ L 243, 11.9.2002, p. 1

² OJ L 222, 14.8.1978, p. 11, Directive as last amended by Directive 2003/51/EC of the European Parliament and of the Council (OJ L 178, 17.07.2003, p.16

³ OJ L 193, 18.7.1983, p. 1, Directive as last amended by Directive 2003/51/EC of the European Parliament and of the Council (OJ L 178, 17.07.2003, p.16

2. THE IAS REGULATION

2.1. Article 3: Adoption and use of international accounting standards

2.1.1. Endorsement criteria of IASs

Whether a standard is suitable for application in the EU will depend on that standard meeting certain criteria set out in the IAS Regulation. These criteria require that IASs:

- are not contrary to the principle set out in Article 16(3) of Council Directive 83/349/EEC and in Article 2(3) of Council Directive 78/660/EEC and
- are conducive to the European public good and,
- meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

In considering whether the application of a standard results in a true and fair view of the financial position and performance of an enterprise, this principle is considered in the light of the said Council Directives without implying a strict conformity with each and every provision of those Directives.

2.1.2. Languages and availability of IASs

Adopted IASs and SICs will be freely available (via the Official Journal) in all Community languages. Adopted standards and interpretations will be published in the Official Journal of the European Union. These standards will also be available on our web site:

http://europa.eu.int/comm/internal_market/accounting/index_en.htm

2.1.3. IASs not yet endorsed and IASs rejected by the EU

Where it applies, the IAS Regulation requires that accounts be prepared in accordance with endorsed IASs i.e. IASs adopted by the EU further to the IAS Regulation. Accordingly, if a standard is not endorsed it is not required or in certain instances not permitted to be applied by a company preparing its accounts further to the IAS Regulation.

To the extent that a standard which has not yet been endorsed by the EU is not inconsistent with endorsed standards and is consistent with the conditions set out in IAS 1 paragraph 22⁴ it may be used as guidance.

⁴ In the absence of a specific International Accounting Standard and an Interpretation of the Standing Interpretations Committee, management uses its judgement in developing an accounting policy that provides the most useful information to users of the enterprise's financial statements. In making this judgement, management considers:

To the extent that a standard has been rejected by the EU but is not inconsistent with endorsed standards and is consistent with the conditions set out in IAS 1 paragraph 22, it may be used as guidance.

To the extent that a rejected standard conflicts with a standard which has been endorsed – for example where an endorsed standard is amended – the rejected standard may not be applied. The company must continue to apply fully the standard endorsed by the EU.

IAS 1 requires that the notes to the financial statements present information about the basis of preparation of the financial statements and the specific accounting policies selected and applied. These requirements will necessitate clear disclosure of both the standards applied and of any other standards or guidance applied by the company further to paragraphs 20 and 22 of IAS 1.

2.1.4. Statement in the accounting policies

The legal requirement in the IAS Regulation is for the accounts to be prepared in accordance with *adopted* IASs i.e. IASs endorsed by the EU. It is therefore appropriate that this should be made clear in the accounting policies. Following the change of name from International Accounting Standards to International Financial Reporting Standards and consistent with the guidance contained in the ‘Preface to Statements of International Accounting Standards’, such a statement should refer to the financial statements having been prepared ‘... in accordance with all International Financial Reporting Standards adopted for use in the European Union’. However, if the application of adopted IFRSs results in financial statements that also comply with all IFRSs, because no standards have been rejected and all standards issued by the IASB have been endorsed, then it would not be necessary to state "adopted for use in the European Union", but simply ‘... in accordance with all International Financial Reporting Standards’.

2.1.5. Status of the IASB Framework, the Appendices to IASs and the Implementation Guidance to IASs

IAS 1 states that the application of International Accounting Standards (IASs) and Interpretations of the Standing Interpretations Committee (SICs) (Interpretations), with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation. IAS 1 states further that financial statements shall not be described as complying with IASs and Interpretations unless they comply with all the requirements of each applicable Standard and Interpretation.

(a) the requirements and guidance in International Accounting Standards dealing with similar and related issues;
(b) the definitions, recognition and measurement criteria for assets, liabilities, income and expenses set out in the IASC Framework; and
(c) pronouncements of other standard setting bodies and accepted industry practices to the extent, but only to the extent, that these are consistent with (a) and (b) of this paragraph.'

IASs set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events that are important in general purpose financial statements. IASs are based on the *Framework for the Preparation and Presentation of Financial Statements* (“the Framework”), which addresses the concepts underlying the information presented in general purpose financial statements. The objective of the Framework is to facilitate the consistent and logical formulation of IASs.

However, the Framework itself is not an IAS or Interpretation and therefore does not need to be adopted into Community law. Nevertheless, it does provide the basis for the use of judgement in resolving accounting issues. This is of particular relevance in situations where there is no particular Standard or Interpretation that specifically applies to an item in the financial statements. In such situations, IASs require management to use their judgement in developing and applying an accounting policy that results in information that is relevant and reliable. In making such judgements, IASs require management to consider, inter alia, the definitions, recognition criteria and measurement concepts set out in the Framework.

Similarly, when an IAS or Interpretation does apply to an item in the financial statements, management is required to select the accounting policy to be applied to that item by considering also any Appendices to the Standard that do not form a part of the IAS (such as the Basis for Conclusions) and any Implementation Guidance issued in respect of the IAS.

In view of its importance to the resolution of accounting issues, the IASB Framework has been annexed to this paper. Users of IASs should, in addition, consult individual IASs and Interpretations in order to ensure that any Appendices and Implementation Guidance are properly considered in determining the appropriate application of IASs.

2.2. Article 4: Consolidated accounts of publicly traded companies

2.2.1. Definition of "companies"

Articles 4 and 5 of the IAS Regulation refer to ‘companies’. Companies are defined by the Treaty of Rome, Article 48 (ex Article 58) as follows:

Article 48 (ex Article 58) second paragraph:

...

"Companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.

This definition is reflected in the scope of each of the following related Accounting Directives, which have as their legal base the Treaty's Article 54 (new Treaty, Article 44), which makes a reference to Article 58 of the Treaty (new Treaty, Article 48),:

- The Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 54(3)(g) of the Treaty (new Treaty version 44(2)(g) on the annual accounts of certain types of companies sets out the requirements in respect of the preparation of the annual accounts of companies⁵.
- The Seventh Council Directive (83/349/EEC) of 13 June 1983 based on Article 54(3)(g) of the Treaty (new Treaty version 44(2)(g) on consolidated accounts sets out the requirements in respect of the preparation of consolidated accounts⁶.
- Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions deals with those matters specific to such institutions⁷ (having regard to Article 54(3)(g) of the Treaty (new Treaty version 44(2)(g); and
- Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings sets out the specific requirements relevant to the preparation of accounts of such entities⁸ (having regard to Article 54 of the Treaty (new Treaty, Article 44).

The IAS Regulation is addressed only to EU companies. It does not set out requirements for non-EU companies.

2.2.2. Definition of "consolidated accounts"

As the IAS Regulation only applies to ‘consolidated accounts’, it only takes effect where such consolidated accounts are otherwise required.

The determination of whether or not a company is required to prepare consolidated accounts will continue to be made by reference to national law transposed from the Seventh Council Directive. For the avoidance of doubt, the following Articles of the Seventh Council Directive are relevant to the existence of such a requirement: Articles 1, 2, 3(1) 4, 5-9, 11, and 12.

These requirements are considered further below.

a) General requirement

Subject to certain exemptions (see (b) below), the Seventh Council Directive (83/349/EEC) sets out the circumstances when a company is required to prepare consolidated accounts.

Where these circumstances (as transposed into national law), require the preparation of consolidated accounts, the requirements of the IAS Regulation apply to those accounts.

⁵ OJ No L222, 14.8.1978, p. 11, Directive as last amended by Directive 2003/51/EC (OJ No L178, 17.07. 2003, p. 16)

⁶ OJ No L193, 18. 7. 1983, p. 1, Directive as last amended by Directive 2003/51/EC (OJ No L178, 17. 07. 2003, p. 16)

⁷ OJ No L372, 31. 12. 1986, p. 1, Directive as last amended by Directive 2003/51/EC (OJ No L178, 17.07. 2003, p. 16)

⁸ OJ No L374, 31. 12. 1991, p. 7, Directive as last amended by Directive 2003/51/EC (OJ No L178, 17.07. 2003, p. 16)

b) Exemptions from the preparation of consolidated accounts

Exemptions from the general requirement to prepare consolidated accounts are set out in Articles 5, 7-11 of the Seventh Council Directive (83/349/EEC). In addition, Article 6 of the Seventh Council Directive provides an exemption on the grounds of size alone.

Where a company is not required to prepare consolidated accounts as a result of an exemption contained in national law derived from the Accounting Directives, the requirements of the IAS Regulation in respect of consolidated accounts do not apply – as there are no ‘consolidated accounts’ to which to apply those requirements.

c) Exclusions from consolidation

Certain exclusions from the scope of the consolidation are provided for in Articles 13 to 15 of the Seventh Directive.

As noted above, it is the national law derived from the Accounting Directives that determines whether or not consolidated accounts are required. However, if consolidated accounts are so required, it is the requirements of endorsed IASs that will dictate the scope of consolidation and, therefore, which entities should be included in those consolidated accounts and how they should be included.

Accordingly, the exclusions from the scope of the consolidation derived from the Accounting Directives are not relevant – the consolidated accounts are prepared in accordance with endorsed IASs.

2.2.3. Interim reporting requirements

There is no direct impact upon interim reporting requirements as the scope of the IAS Regulation covers only annual and consolidated accounts.

To the extent that a company is required to prepare an interim report and where that report is prepared on a basis consistent with the annual (or consolidated) accounts, it is clear that there is an indirect impact of the change to IASs.

It should be noted that the Commission has recently made a proposal for a directive on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC. This directive establishes requirements in relation to the disclosure of periodic and ongoing information about issuers whose securities are already admitted to trading on a regulated market situated or operating within a Member State. Further information can be found at the web site: http://europa.eu.int/comm/internal_market/en/finances/mobil/transparency/index.htm

CESR (Committee of European Securities Regulators) has issued for public consultation a draft recommendation for additional guidance regarding the transition to IFRS in 2005. This recommendation articulates a number of proposals to ensure a smooth transition to IAS through proper interim information in 2005. CESR recommends that market participants be provided

during 2005 with financial information consistent with the IAS-based information they will receive relating to the full year ending on or after 31 December 2003. Listed companies are therefore encouraged to use the same IAS measurement and recognition principles for preparing interim financial reports as for their year-end reporting under IAS. Further information can be found on the web site of CESR: www.europefesco.org.

2.3. Use of IASs before 2005

In terms of listed companies⁹, the IAS Regulation is directly applicable to their consolidated accounts. Article 4 of the IAS Regulation contains no requirements prior to 2005 and envisages no voluntary early adoption.

This would suggest that, solely on the basis of the IAS Regulation, adopted (i.e. endorsed) IASs would not be permitted or required prior to 2005.

However, on 13 June 2000, the Commission adopted its Communication *The EU's Financial Reporting Strategy: the Way Forward* (COM (2000)359, 13.06.2000). The Communication proposed that all EU listed companies should be required to prepare their consolidated accounts in accordance with a single set of accounting standards, namely International Accounting Standards (IASs), from 2005 at the latest. This strategy has been endorsed by the Commission and Member States through the IAS Regulation.

Consequently, it would not be inconsistent with this strategy for Member States to permit or require listed companies to prepare their consolidated accounts for a year prior to 2005 in accordance with IASs under national law.

In terms of private companies (and annual accounts), the IAS Regulation applies via the Member State option in Article 5. This article does not have any time reference. Member States may therefore permit or require consolidated accounts of unlisted companies and annual accounts to be prepared in accordance with endorsed IASs as soon as they choose.

2.4. Clarification of Article 9

Where a Member State exercises the option in Article 9(a) of the IAS Regulation i.e. to exempt companies whose debt securities are listed in the EU, the extension until 2007 applies only in respect of companies that are using internationally accepted standards as the basis for their primary statements in their statutorily required consolidated accounts, for the purposes of a non-EU listing. It does not apply where national GAAP is used, even if reconciliation to internationally accepted standards is provided either within or separate to the statutory consolidated accounts. Similarly, there is no extension to 2007 where separate, non-statutory accounts are prepared on the basis of internationally accepted standards.

⁹ 'Listed Companies' means those companies whose securities are admitted to trading on a regulated market of any Member State within the meaning of Article 1(13) of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field.

The extension is also unavailable where required compliance with national GAAP happens to lead to compliance with internationally accepted standards also. Such coincidence may be transitory – the appropriate test is whether internationally accepted standards are permitted as the basis for the preparation of the primary statements and have been so adopted.

3. THE INTERACTION BETWEEN THE IAS REGULATION AND THE ACCOUNTING DIRECTIVES

3.1. Annual and consolidated accounts of listed EU companies

Article 5 of the IAS Regulation sets out an option, allowing Member States to permit or require the application of adopted IASs in the case of annual accounts of listed EU companies.

In respect of the consolidated accounts of listed EU companies, the IAS Regulation is directly applicable to the company drawing up accounts. The Accounting Directives apply to companies through their transposition into national law.

Accordingly, there is no direct interaction between a Directive and a Regulation as only one is directly applicable to companies. Accordingly, the issue properly concerns the interaction of national law and the IAS Regulation.

The issue of interaction is only relevant to the extent that national law deals with the same subject matter as the IAS Regulation. Some aspects of national law transposed from the Accounting Directives deal with matters outside the scope of the IAS Regulation and will continue to apply, for example the annual report (Fourth Directive, Article 46). In this instance, the IAS Regulation deals solely with ‘consolidated accounts’ (together with certain options in respect of annual accounts). It follows that the additional information in or accompanying the annual (and consolidated annual) report falls outside the scope of the IAS Regulation.

Other matters which are dealt with in the Accounting Directives, which are outside the scope of the IAS Regulation and will continue to apply include:

- Publication: Article 47 of the Fourth and Article 38 of the Seventh Directives;
- Audit matters: Articles 48 and 51 of the Fourth and Article 37 of the Seventh Directives,
- Other matters: Article 53 of the Fourth Directive.

To the extent that the scope is the same (i.e. with respect to the consolidated or annual accounts themselves), the interaction is as follows:

No transposed provision of the Accounting Directives may restrict or hinder a company’s compliance with (or choice under) adopted IASs, further to the IAS Regulation. In other words, a company applies endorsed IASs irrespective of any contrary, conflicting or restricting requirements in national law. As such, Member States are not able to restrict explicit choices contained in IASs.

In a principles-based system such as IASs there will always exist transactions or arrangements that are not covered by explicit rules. In such circumstances IASs specifically require management to use its judgement to determine the most appropriate accounting treatment (IAS 1, paragraph 22). This judgement does not amount to a free choice, as IASs require that it is exercised having regard to the IASB Framework, definitions, other standards and best practice. Consistent with the application of adopted IASs further to the IAS Regulation, national law may not, by specifying particular treatments, restrict or hinder this requirement to apply judgement in the manner envisaged.

As the IAS Regulation is directly applicable, Member States will ensure that they do not seek to apply to the company any additional elements of national law that are contrary to, conflict with or restrict a company's compliance with adopted IASs, further to the IAS Regulation.

3.2. Annual and consolidated accounts of unlisted companies

Article 5 of the IAS Regulation sets out an option, allowing Member States to permit or require the application of adopted IASs in the case of annual accounts and/or the consolidated accounts of unlisted EU companies.

Where a Member State so requires the use of IASs, further to Article 5 of the IAS Regulation, IASs become directly applicable to those accounts of the company.

Accordingly, the same interaction applies in respect of the annual accounts and the consolidated accounts of unlisted companies that are prepared further to the implementation of the Member State option in Article 5 of the IAS Regulation as applies in the case of the consolidated accounts of listed EU companies.

This interaction is the same irrespective of whether the accounts are prepared in accordance with IASs as a result of a *requirement* that they be so prepared, or as a result of a choice given to the company by national law further to Article 5.

3.3. Articles of the transposed Accounting Directives still applying to companies after the IAS Regulation

The general interaction of the IAS Regulation and the transposed Accounting Directives is discussed under paragraphs 3.1 and 4.1. The specific interaction concerning the entities to be included in consolidated accounts prepared in accordance with endorsed IASs is considered in paragraph 2.2.2.

A company which is required to prepare **consolidated accounts** and which falls within the scope of the IAS Regulation as a result of either the application of Article 4 or of Article 5 of the IAS Regulation, is required to comply with national law transposed from those Articles in the Fourth

and Seventh Directives that deal with the audit, consolidated annual report and certain disclosures that are beyond the scope of International Accounting Standards. For the avoidance of doubt, the following Articles in the Fourth and Seventh Council Directives continue to be relevant to such consolidated accounts:

- (a) In the case of the Fourth Council Directive, Article 58(c); and
- (b) In the case of the Seventh Council Directive, Articles 34(2)-(5), 34(9), 34(12), 34(13), 35(1), 36, 37, and 38.

A company which is required to prepare **annual accounts** and which falls within the scope of the IAS Regulation as a result of the application of Article 5 of the IAS Regulation, is required to comply with national law transposed from those Articles in the Fourth and Seventh Directives that deal with the audit, annual report and certain disclosures that are beyond the scope of International Accounting Standards. For the avoidance of doubt, the following Articles in the Fourth and Seventh Council Directives continue to be relevant to such annual accounts:

- (a) In the case of the Fourth Council Directive, Articles 11, 12, 27, 43(1)(2), 43(1)(9), 43(1)(12), 43(1)(13), 45(1), 46, 47(1), 47(1a), 47(2) last sentence, 48, 49, 51, 51a, 53, 56(2), 57 and 58.
- (b) In the case of the Seventh Council Directive, Article 9(2)

3.4. IASs as part of national accounting law

Companies which are not subject to the IAS Regulation continue to have national accounting requirements derived from the Accounting Directives as the basis for their accounts.

Provided that a given IAS is consistent with a transposition of the Accounting Directives, Member States may require that IAS to be applied by such companies. Clearly, such a requirement could be extended to cover all IASs and their interpretations.

In such instances, the company remains under the requirements of national law and the restriction upon additional measurement or disclosure requirements as part of that national law referred to in paragraphs 3.1 and 4.1 do not apply.

4. DISCLOSURE ISSUES

4.1. Member State requirements of additional disclosures above IASs

The maximum benefits of the application of a single financial reporting framework as envisaged in the IAS Regulation, whereby all relevant accounts are directly comparable, will be achieved where Member States do not seek disclosure, in the annual or consolidated accounts prepared in accordance with adopted IASs further to the IAS Regulation, of qualitative or quantitative

disclosures that are not relevant to such general purpose financial statements or of information that would more appropriately be reported separately.

Consistent with the interaction of national law and IASs considered in paragraph 3.1, additional disclosure requirements included in national law, whether transposed from the Accounting Directives or at the initiative of the Member State itself, may continue to apply where they are relevant to such general purpose financial statements and are outside the scope of endorsed IASs.

Additional disclosure may still be required by e.g. supervisory authorities or securities regulators of matters which:

- are to be given outside the annual (or consolidated) accounts to which the IAS Regulation applies – say in the annual report or in a separate schedule annexed to the accounts; or
- are to be given within the notes to the annual (or consolidated) accounts to which the IAS Regulation applies when the subject matter is perceived as highly relevant to those general purpose accounts (for example, certain corporate governance related disclosures such as management remuneration by individual) but falls outside the scope of IASs as it is not necessary for the presentation of a true and fair view in accordance with IASs.

4.2. IASs formats and a chart of accounts

IASs describe the manner in which the items disclosed on the face of the profit and loss account and the balance sheet should be determined.

In respect of the profit and loss account, IASs permit two approaches, disclosure by *function* or by *nature*. Where disclosure by function is adopted, certain additional information by nature is required. Disclosure by function or nature follows the same principles that determine the alternative formats set out in the Fourth Council Directive.

In respect of the balance sheet, assets are presented either in order of their liquidity or on the basis of a current/non-current distinction. These presentations are very similar to those envisaged by the Fourth Council Directive which requires distinctions between fixed and current assets and between short- and long term liabilities.

As IASs are only relevant to external, general purpose financial reporting, there are no explicit requirements in IASs concerning the structure of the internal management information (or chart of accounts) which must be maintained by the company; though clearly such internal information must be at least sufficient to support the preparation of the information required for external financial reporting.

As the IAS Regulation applies directly to individual companies, Member States cannot impose their own formats and therefore endorsed IASs shall be applied.

5. ANNEX

Framework for the Preparation and Presentation of Financial Statements

The IASB Framework was approved by the IASC Board in April 1989 for publication in July 1989, and adopted by the IASB in April 2001.

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Preface

Financial statements are prepared and presented for external users by many enterprises around the world. Although such financial statements may appear similar from country to country, there are differences which have probably been caused by a variety of social, economic and legal circumstances and by different countries having in mind the needs of different users of financial statements when setting national requirements.

These different circumstances have led to the use of a variety of definitions of the elements of financial statements; that is, for example, assets, liabilities, equity, income and expenses. They have also resulted in the use of different criteria for the recognition of items in the financial statements and in a preference for different bases of measurement. The scope of the financial statements and the disclosures made in them have also been affected.

The International Accounting Standards Committee (IASC) is committed to narrowing these differences by seeking to harmonise regulations, accounting standards and procedures relating to the preparation and presentation of financial statements. It believes that further harmonisation can best be pursued by focusing on financial statements that are prepared for the purpose of providing information that is useful in making economic decisions.

The Board of IASC believes that financial statements prepared for this purpose meet the common needs of most users. This is because nearly all users are making economic decisions, for example, to:

- (a) decide when to buy, hold or sell an equity investment;
- (b) assess the stewardship or accountability of management;
- (c) assess the ability of the enterprise to pay and provide other benefits to its employees;
- (d) assess the security for amounts lent to the enterprise;
- (e) determine taxation policies;
- (f) determine distributable profits and dividends;
- (g) prepare and use national income statistics; or
- (h) regulate the activities of enterprises.

The Board recognises, however, that governments, in particular, may specify different or additional requirements for their own purposes. These requirements should not, however, affect financial statements published for the benefit of other users unless they also meet the needs of those other users.

Financial statements are most commonly prepared in accordance with an accounting model based on recoverable historical cost and the nominal financial capital maintenance concept. Other models and concepts may be more appropriate in order to meet the objective of providing information that is useful for making economic decisions although there is presently no consensus for change. This Framework has been developed so that it is applicable to a range of accounting models and concepts of capital and capital maintenance.

Introduction

Purpose and Status

1. This Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Framework is to:
 - (a) assist the Board of IASC in the development of future International Accounting Standards and in its review of existing International Accounting Standards;
 - (b) assist the Board of IASC in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International Accounting Standards;
 - (c) assist national standard-setting bodies in developing national standards;
 - (d) assist preparers of financial statements in applying International Accounting Standards and in dealing with topics that have yet to form the subject of an International Accounting Standard;
 - (e) assist auditors in forming an opinion as to whether financial statements conform with International Accounting Standards;
 - (f) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with International Accounting Standards; and
 - (g) provide those who are interested in the work of IASC with information about its approach to the formulation of International Accounting Standards.
2. This Framework is not an International Accounting Standard and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Framework overrides any specific International Accounting Standard.
3. The Board of IASC recognises that in a limited number of cases there may be a conflict between the Framework and an International Accounting Standard. In those cases where there is a conflict, the requirements of the International Accounting Standard prevail over those of the Framework. As, however, the Board of IASC will be guided by the Framework in the development of future Standards and in its review of existing Standards, the number of cases of conflict between the Framework and International Accounting Standards will diminish through time.
4. The Framework will be revised from time to time on the basis of the Board's experience of working with it.

Scope

5. The Framework deals with:
 - (a) the objective of financial statements;
 - (b) the qualitative characteristics that determine the usefulness of information in financial statements;
 - (c) the definition, recognition and measurement of the elements from which financial statements are constructed; and
 - (d) concepts of capital and capital maintenance.
6. The Framework is concerned with general purpose financial statements (hereafter referred to as "financial statements") including consolidated financial statements. Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in

view. Special purpose financial reports, for example, prospectuses and computations prepared for taxation purposes, are outside the scope of this Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.

7. Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, an income statement, a statement of changes in financial position (which may be presented in a variety of ways, for example, as a statement of cash flows or a statement of funds flow), and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about industrial and geographical segments and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.
8. The Framework applies to the financial statements of all commercial, industrial and business reporting enterprises, whether in the public or the private sectors. A reporting enterprise is an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

Users and Their Information Needs

9. The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. These needs include the following:
 - (a) *Investors.* The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the enterprise to pay dividends.
 - (b) *Employees.* Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
 - (c) *Lenders.* Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
 - (d) *Suppliers and other trade creditors.* Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuation of the enterprise as a major customer.
 - (e) *Customers.* Customers have an interest in information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.
 - (f) *Governments and their agencies.* Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises, determine taxation policies and as the basis for national income and similar statistics.
 - (g) *Public.* Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.
10. While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the enterprise, the provision of financial

statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

11. The management of an enterprise has the primary responsibility for the preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this Framework. Nevertheless, published financial statements are based on the information used by management about the financial position, performance and changes in financial position of the enterprise.

The Objective of Financial Statements

12. The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.
13. Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.
14. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

Financial Position, Performance and Changes in Financial Position

15. The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay loans and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and changes in financial position of an enterprise.
16. The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the enterprise and its capacity in the past to modify these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future after taking account of financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.
17. Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources.
18. Information concerning changes in the financial position of an enterprise is useful in order to assess its investing, financing and operating activities during the reporting period. This information is useful in providing the user with a basis to assess the ability of the enterprise to generate cash and cash equivalents and

the needs of the enterprise to utilise those cash flows. In constructing a statement of changes in financial position, funds can be defined in various ways, such as all financial resources, working capital, liquid assets or cash. No attempt is made in this Framework to specify a definition of funds.

19. Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in an income statement. Information about changes in financial position is provided in the financial statements by means of a separate statement.
20. The component parts of the financial statements interrelate because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose or provide all the information necessary for particular needs of users. For example, an income statement provides an incomplete picture of performance unless it is used in conjunction with the balance sheet and the statement of changes in financial position.

Notes and Supplementary Schedules

21. The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about geographical and industry segments and the effect on the enterprise of changing prices may also be provided in the form of supplementary information.

Underlying Assumptions

Accrual Basis

22. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going Concern

23. The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Qualitative Characteristics of Financial Statements

24. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

25. An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

Relevance

26. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.
27. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.
28. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, security price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed.

Materiality

29. The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the enterprise irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.
30. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Reliability

31. To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the enterprise to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful Representation

33. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.
34. Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance Over Form

35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).

Neutrality

36. To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

37. The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Completeness

38. To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Comparability

39. Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.
40. An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with International Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.
41. The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.
42. Because users wish to compare the financial position, performance and changes in financial position of an enterprise over time, it is important that the financial statements show corresponding information for the preceding periods.

Constraints on Relevant and Reliable Information

Timeliness

43. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.

Balance between Benefit and Cost

44. The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared; for example, the provision of further information to lenders may reduce the borrowing costs of an enterprise. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

45. In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

True and Fair View/Fair Presentation

46. Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

The Elements of Financial Statements

47. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the income statement are income and expenses. The statement of changes in financial position usually reflects income statement elements and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.
48. The presentation of these elements in the balance sheet and the income statement involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Position

49. The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:
 - (a) An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
 - (b) A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
 - (c) Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.
50. The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 82 to 98. In particular, the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion in paragraph 83 before an asset or liability is recognised.
51. In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the lessee's balance sheet.
52. Balance sheets drawn up in accordance with current International Accounting Standards may include items that do not satisfy the definitions of an asset or liability and are not shown as part of equity. The definitions set out in paragraph 49 will, however, underlie future reviews of existing International Accounting Standards and the formulation of further Standards.

Assets

53. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.
54. An enterprise usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay

for them and hence contribute to the cash flow of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

55. The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be:
 - (a) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;
 - (b) exchanged for other assets;
 - (c) used to settle a liability; or
 - (d) distributed to the owners of the enterprise.
56. Many assets, for example, property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the enterprise and if they are controlled by the enterprise.
57. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the enterprise controls the benefits which are expected to flow from the property. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.
58. The assets of an enterprise result from past transactions or other past events. Enterprises normally obtain assets by purchasing or producing them, but other transactions or events may generate assets; examples include property received by an enterprise from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.
59. There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet; for example, items that have been donated to the enterprise may satisfy the definition of an asset.

Liabilities

60. An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.
61. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party.

62. The settlement of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:
- (a) payment of cash;
 - (b) transfer of other assets;
 - (c) provision of services;
 - (d) replacement of that obligation with another obligation; or
 - (e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

63. Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade payables (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.
64. Some liabilities can be measured only by using a substantial degree of estimation. Some enterprises describe these liabilities as provisions. In some countries, such provisions are not regarded as liabilities because the concept of a liability is defined narrowly so as to include only amounts that can be established without the need to make estimates. The definition of a liability in paragraph 49 follows a broader approach. Thus, when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

65. Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, in a corporate enterprise, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.
66. The creation of reserves is sometimes required by statute or other law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Other reserves may be established if national tax law grants exemptions from, or reductions in, taxation liabilities when transfers to such reserves are made. The existence and size of these legal, statutory and tax reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.
67. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.
68. Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applying to corporate enterprises. For example, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such enterprises.

Performance

69. Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements. These concepts are discussed in paragraphs 102 to 110.
70. The elements of income and expenses are defined as follows:
 - (a) Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
 - (b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.
71. The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that would need to be met before they are recognised in the income statement. Criteria for the recognition of income and expenses are discussed in paragraphs 82 to 98.
72. Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the enterprise to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items in this way consideration needs to be given to the nature of the enterprise and its operations. Items that arise from the ordinary activities of one enterprise may be unusual in respect of another.
73. Distinguishing between items of income and expense and combining them in different ways also permits several measures of enterprise performance to be displayed. These have differing degrees of inclusiveness. For example, the income statement could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

74. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.
75. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in this Framework.
76. Gains include, for example, those arising on the disposal of non-current assets. The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long term assets. When gains are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Gains are often reported net of related expenses.
77. Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result from the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

78. The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the enterprise. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of sales, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment.
79. Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.
80. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses, for example, those arising from the effects of increases in the rate of exchange for a foreign currency in respect of the borrowings of an enterprise in that currency. When losses are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Losses are often reported net of related income.

Capital Maintenance Adjustments

81. The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 102 to 110 of this Framework.

Recognition of the Elements of Financial Statements

82. Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 83. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals. Items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.
83. An item that meets the definition of an element should be recognised if:
- (a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
 - (b) the item has a cost or value that can be measured with reliability.
84. In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraphs 29 and 30. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The Probability of Future Economic Benefit

85. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable owed by an enterprise will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence an expense representing the expected reduction in economic benefits is recognised.

Reliability of Measurement

86. The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this Framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement. For example, the expected proceeds from a lawsuit may meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is not possible for the claim to be measured reliably, it should not be recognised as an asset or as income; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.
87. An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 83 may qualify for recognition at a later date as a result of subsequent circumstances or events.
88. An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or in supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and changes in financial position of an enterprise by the users of financial statements.

Recognition of Assets

89. An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably.
90. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead such a transaction results in the recognition of an expense in the income statement. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

Recognition of Liabilities

91. A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of Income

92. Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).
93. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

Recognition of Expenses

94. Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).
95. Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.
96. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated

with the using up of assets such as property, plant, equipment, goodwill, patents and trademarks; in such cases the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

97. An expense is recognised immediately in the income statement when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.
98. An expense is also recognised in the income statement in those cases when a liability is incurred without the recognition of an asset, as when a liability under a product warranty arises.

Measurement of the Elements of Financial Statements

99. Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.
100. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:
- (a) *Historical cost.* Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.
 - (b) *Current cost.* Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
 - (c) *Realisable (settlement) value.* Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.
 - (d) *Present value.* Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.
101. The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value. Furthermore, some enterprises use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Concepts of Capital and Capital Maintenance

Concepts of Capital

102. A financial concept of capital is adopted by most enterprises in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.
103. The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of Capital Maintenance and the Determination of Profit

104. The concepts of capital in paragraph 102 give rise to the following concepts of capital maintenance:
 - (a) *Financial capital maintenance.* Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.
 - (b) *Physical capital maintenance.* Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the enterprise (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.
105. The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a net loss.
106. The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain.
107. The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.
108. Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

109. Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.
110. The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time, it is not the intention of the Board of IASC to prescribe a particular model other than in exceptional circumstances, such as for those enterprises reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of world developments.